"Build Back Better" Tax Proposals Approved by the House Ways & Means Committee

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To paraphrase Frank Zappa,[1] "[t]he United States is a nation of laws, densely written and randomly enforced." Nowhere is this truer than with respect to the tax laws contained in the US Internal Revenue Code (the "Code"). On September 15, 2021, the Ways & Means Committee of the US House of Representatives continued this grand tradition with its approval of what would amount to a significant overhaul of the Code with the "Build Back Better Act" (the "BBBA"). While there are likely to be changes before anything is enacted, the Ways & Means bill provides us a blueprint for what is in store. In this Legal Update, your intrepid Mayer Brown Tax Team provides a selective overview of proposed legislation.

Part I – Corporate and International Tax Reforms

A. INCREASE IN CORPORATE TAX RATES AND THE CORPORATE DIVIDEND RECEIVED DEDUCTION

In 2017, with the enactment of the Tax Cuts and Jobs Act (the "TCJA"), Congress imposed a flat tax rate of 21% on the taxable income of corporations. The TCJA repealed the prior graduated corporation income tax rate, including the prior maximum rate of 35%. The BBBA would replace the flat corporate income tax with a graduated tax rate structure as follows. A corporation's taxable income that: (i) does not exceed $400,000 would be subject to a new 18% tax rate; (ii) exceeds $400,000, but does not exceed $5 million, would be subject to a 21% tax rate; and (iii) exceeds $5 million would be subject to a 26.5% tax rate. Additionally, any taxes owed by corporations with income in excess of $10 million would be increased by the lesser of (i) 3% of the excess or (ii) $287,000. The proposal would not apply to qualified personal service corporations (as defined in Code § 448(d)(2)). Instead, these corporations would be subject to a flat corporate tax rate of 26.5% on all taxable income.

Under the BBBA, deductions on dividends received from a domestic corporation under Code § 243 would be increased from 65% to 72.5% for dividends received from 20% owned corporations and from 50% to 60% for other dividends that are not qualifying dividends. These changes would be effective for tax years beginning after December 31, 2021.

B. NEW LIMITATION ON THE DEDUCTION OF INTEREST BY "SPECIFIED DOMESTIC CORPORATIONS"

Code § 163(j) already limits the amount of net business interest that most taxpayers can deduct. The BBBA proposes a new limit on net interest deductions, that is, interest expense in excess of interest income, in what would be new Code § 163(n), for tax years beginning in 2022. The Code § 163(n)

limit would apply only if it disallowed more interest deductions than existing Code § 163(j). Like Code § 163(j), Code § 163(n) would not apply to certain small businesses.

Parsing the application of Code § 163(n) is made easier by starting with certain definitions used in the proposed Code section. First, the new limits only apply to "specified domestic corporations" (an "SDC"). An SDC is any US corporation (other than an exempted small business) if its average annual interest expense over its average annual net interest income during the current year and the two preceding years exceeds $12 million. An SDC then will only be subject to the proposed interest deduction limit if it is a member of an "international financial reporting group" (an "IFRG"). An IFRG is a group of two or more corporations, one of which is non-US, if they prepare a GAAP or IFRS financial statement for non-tax purposes, including for shareholders or creditors. A non-US corporation with a US branch is treated as an IFRG if it uses GAAP or IFRS financial statements.

An SDC that is part of an IFRG would compute the Code § 163(n) interest limitation in the following manner. First, the SDC computes the "allowable percentage." The allowable percentage is 110% of the SDC's share of the IFRG's reported net interest expense ("GRNIE") divided by the SDC's reported net interest expense (the "DCRNIE"). The SDC's share of the fraction is the ratio obtained by comparing the SDC's share of EBITDA to the IFRG's EBITDA. If the IFRG has zero or negative EBITDA, Code § 163(n) does not apply in that year. If, however, the IFRG has EBITDA but the SDC has zero or negative EBITDA, Code § 163(n) disallows all net interest expense of the SDC.

Maybe an example would help (maybe). Assume Foreign Parent ("FP") has $1,000x of EBITDA and SDC has $500x of EBITDA. The ratio of US EBITDA to IFRG EBIDTA is 33.3% (500/1,500). FP has $1,000x of debt outstanding bearing interest at 5%. FP has loaned $1,000x to SDC at 6% and incurs DCRNIE of $60x. On a consolidated basis, only the $50x of interest paid by FP is reported as GRNIE (the FP-SDC loan is eliminated in consolidation). SDC's share of the $50x GRNIE is $16.65x (⅓ x $50x). SDC's allowable percentage is 27.75% ($16.65x/$60x). Proposed Code § 163(n) would limit SDC's share of interest expense to $15.26x, that is, 110% of $50x GRNIE multiplied by the 27.75%. Thus, SDC would lose the current deduction for $44.73x ($60x interest paid to FP minus the Code § 163(n) limit).

Interest that is disallowed under Code § 163(n), as a well as interest disallowed under Code § 163(j) in 2022 and thereafter carries forward for five years. If the disallowed interest is not utilized within such period, it disappears.

C. CHANGES TO CODE § 163(J)

Under current law, Code § 163(j) applies to partnerships and S corporation at the entity level. The BBBA would modify Code § 163(j)(4), which applies the limitation on deductibility of business interest under Code § 163(j) to partnerships and S corporations, so that the limitation on interest generally would apply at the partner or shareholder level. These changes would be effective for the tax years beginning after December 31, 2021.

The proposal also includes a transition rule for partners that have been allocated excess business interest expense. For tax years beginning after December 31, 2021, any outstanding excess business interest that was allocated to a partner would be treated as paid or accrued by the partner in such tax year.

D. REDUCTION OF CODE § 250 DEDUCTION FOR FDII AND GILTI

The BBBA would accelerate the reductions to the deduction under Code § 250 for global intangible low-taxed income ("GILTI") and foreign derived intangible income ("FDII") that are currently scheduled to go into effect in 2026. For tax years beginning after December 31, 2021, the deduction for FDII would be reduced to 21.875% and the deduction for GILTI to 37.5% which, taking into account the increase of the corporate tax rate to 26.5%, would yield an effective rate of 16.5625% for GILTI and 20.7% for FDII. The proposal for a 16.5625% effective rate on GILTI appears to signal the United States' recognition of the OECD's commitment to a global minimum tax rate of at least 15% under OECD Pillar Two. A transition rule is included for fiscal year taxpayers that would apply a blended rate for FDII and GILTI based on the portion of the tax year which precedes January 1, 2022.

In addition, the BBBA would eliminate the rule that limits the Code § 250 deduction to the current year's taxable income and, thus, would provide that the excess of the Code § 250 deduction over the current year's taxable income increases the net operating loss for the year. This taxpayer-favorable change would be effective for tax years beginning after December 31, 2021.

E. CHANGES TO SCOPE OF FDII

The BBBA would modify the definition of "deduction eligible income" for FDII purposes, notably excluding from such definition any income which would be foreign personal holding company income if earned by a controlled foreign corporation ("CFC") and any inclusion from a "qualified electing fund" ("QEF inclusion") under the passive foreign investment company ("PFIC") rules. The Joint Committee on Taxation had observed in its TCJA Blue Book that these exclusions had been intended by Congress, but that a "technical correction" would be needed to reflect this intent. Accordingly, the BBBA proposes to introduce these changes as technical corrections and would make them retroactive to 2018. Interestingly, the exclusion for income that would be foreign personal holding company income would deny the benefits of FDII to a US corporation receiving royalty income from a non-CFC foreign affiliate. Taxpayers that have been claiming an FDII deduction with respect to this type of income should monitor whether this change is ultimately enacted with the proposed retroactive date.

F. REPEAL OF ELECTION FOR 1-MONTH DEFERRAL IN CFC TAX YEAR

Under current law, a CFC that is majority owned by a single US shareholder is generally required to adopt the tax year of its majority US shareholder. An exception exists, however, that allows such a CFC to elect to use a tax year that begins one month earlier than its majority US shareholder's tax year. This one-month deferral rule has often allowed taxpayers to delay the application of changes in law to their CFCs and has more generally resulted in unintended consequences in the application of newly enacted rules.

The BBBA would eliminate this one-month deferral rule for taxable years of CFCs beginning after November 30, 2021. For US shareholder-majority owned CFCs that have elected into the one-month deferral, a transition rule would conform the CFC's tax year to its majority US shareholder's tax year by ending the first tax year of the CFC beginning after November 30, 2021, at the same time as the tax year of the majority US shareholder.

G. MODIFICATIONS TO FOREIGN TAX CREDIT LIMITATIONS

The BBBA includes several substantial changes related to the calculation of foreign tax credits.

Importantly, the BBBA would require the foreign tax credit limitation for each foreign tax credit basket to be calculated on a country-by-country ("CbC") basis. For purposes of this CbC calculation, each item of income shall be attributed to a "taxable unit" of the US taxpayer. Taxable units include (i) the US taxpayer itself, (ii) each CFC of which the US taxpayer is a US shareholder, (iii) an interest in a pass-through entity held by the US taxpayer or by any such CFC that is a tax resident in a foreign country and (iv) a branch of the US taxpayer or any such CFC that has a taxable presence in a foreign country. Income of the same foreign tax credit basket earned by taxable units within the same country would be combined for purposes of calculating the taxpayer's foreign tax credit limitation for such category and country. This proposal would prevent taxpayers from cross-crediting "high" and "low" taxed income earned in different jurisdictions and, for many multinational companies, would exponentially increase their US tax compliance and reporting burden. Under rules to be issued by Treasury, the CbC limitation would also apply to foreign tax credits that are carried over from tax years prior to the BBBA coming into effect.

The BBBA would eliminate the "foreign branch income" separate basket that had been introduced by the TCJA, thus reducing the principal foreign tax credit categories to three — passive category income, general category income and GILTI.

The BBBA would also eliminate the one-year carryback for excess foreign tax credits and would bring the current 10-year carryforward period down to five years. Notably, the BBBA would extend the five-year carryforward to excess foreign tax credits in the GILTI basket, alleviating some of the harsh results under the current rules that preclude the carryover of excess GILTI foreign tax credits. These changes would only apply to foreign taxes paid or accrued in tax years beginning after December 31, 2021.

Under current law, as interpreted by the IRS in regulations, interest, stewardship and R&D expenses are apportioned to GILTI, which may significantly lower the foreign tax credit limitation in the GILTI basket. In a taxpayer-favorable change, the BBBA provides that only the Code § 250 deduction, but no expenses of the US shareholder (e.g., interest expense), are allocable to the GILTI basket.

The BBBA would apply the principles of Code § 338(h)(16) in determining the source and character of any item of income or loss in the case of a "covered asset disposition," which is defined as any transaction that is treated as a disposition of assets for US tax purposes and that is treated as a disposition of stock of a corporation (or is disregarded) for non-US tax purposes. In that case, for foreign tax credit purposes, the source and character of any item would be determined based on the source and character that the US shareholder of the target corporation would have taken into account had the sale been treated as a sale of stock for US tax purposes.

Finally, the BBBA would modify the periods during which a taxpayer may elect to claim a credit or a deduction for foreign taxes. A taxpayer may claim a foreign tax credit within five years from the date the return for the tax year in which the taxes are paid is required to be filed but, conversely, would only have three years to change from a credit to a deduction for foreign taxes.

H. MODIFICATIONS TO INCLUSION OF GILTI

The current global intangible low-taxes income ("GILTI") regime of Code § 951A require "US shareholders," that is, holders of 10% or more of the stock of one or more controlled foreign corporations (each, a "CFC"), to include the net earnings of their CFCs in their income to the extent that the CFCs earn more than a deemed 10% return on their qualified business asset investment

("QBAI"). QBAI includes tangible personal property. The BBBA would make several changes to the GILTI rules for tax years beginning in 2022.

First, the BBBA would reduce the deemed exempt QBAI earnings to 5% unless the CFC operates in a US territory.

Second, the BBBA would implement a CbC rule for determining GILTI inclusions. Under this CbC rule, instead of netting all CFC earnings, a US shareholder would only net earnings and losses of CFCs doing business in the same country. The resulting complexity for the distribution of previously taxed earnings and profits ("PTEP") appears to be staggering.

Third, in a significant improvement to the operation of the GILTI regime, net tested losses for a tax year would no longer disappear. Instead, net tested losses, subject to the new CbC rule, would carryforward indefinitely until fully utilized against tested income. Unfortunately, no carryback rule has been proposed.

I. MODIFICATIONS TO DETERMINATION OF DEEMED PAID CREDIT FOR TAXES PROPERLY ATTRIBUTABLE TO GILTI TESTED INCOME

The BBBA would reduce from 20% to 5% the haircut on foreign taxes attributable to tested income under the GILTI rules. In other words, 95% of the foreign taxes attributable to tested income would be creditable. Because, as explained above, no deductions other than the Code § 250 deduction would be allocable to the GILTI basket for purposes of the foreign tax credit limitation, this should mean that a US shareholder would generally not incur residual US tax on its GILTI income so long as the income is subject to a foreign tax rate of approximately 17.43% (i.e., 17.43% * 95% = 16.5625%).

The BBBA would also change the existing GILTI rules to allow a credit for foreign taxes attributable to a tested loss CFC.

Finally, the BBBA provides that, subject to regulations, a credit would be granted for the foreign taxes paid by the foreign parent of a US group that owns CFCs to the extent such foreign taxes are properly attributable to amounts of any such CFCs that are taken into account in determining the US group's tested income or loss. It appears that this provision intends to allow a foreign-parented US group to claim a credit for the foreign taxes paid by its foreign parent under an income inclusion rule in line with the OECD Pillar 2 agreement.

J. REINSTATEMENT OF THE "NO DOWNWARDS ATTRIBUTION" RULE

Inexplicably, the TCJA repealed Code § 958(b)(4), which prevented the "downward attribution" of stock ownership from a foreign person to a U.S. person for purposes of determining whether a US person was a US shareholder or whether a foreign corporation was a CFC. This change was made effective for the last tax year of CFCs that began before January 1, 2018 and had the impact of significantly increasing the number of foreign corporations that were treated as CFCs, even though the change did not appear to have a significant revenue effect. The BBBA would reinstate Code § 958(b)(4) with an effective date of the last tax year of a CFC that began before January 1, 2018, and the tax year of U.S. persons in which or with which such tax year ends, –effectively treating the repeal under the TCJA as if it had never been enacted.

Taxpayers that were US shareholders of entities that were treated as CFCs solely because of the effects of the repeal of Code § 958(b)(4) may be entitled to a refund for any CFC income reported since 2018, provided they do not qualify as "Foreign Controlled U.S. Shareholder" of a "Foreign Controlled CFC", as described below.

K. AMENDMENTS TO CODE § 245A

Generally, the participation exemption system enacted by Congress in TCJA allows a domestic corporation to deduct 100% of the foreign-source portion of dividends ("DRD") received from a "specified foreign corporation" (an "SFC") if the domestic corporation is a "US shareholder" (generally, a 10% or greater owner) of such SFC. An SFC is any foreign corporation with respect to which any domestic corporation is a US shareholder, regardless of whether the SFC is a CFC.

In order to be able to claim the DRD under the current rules, the corporate US shareholder generally must hold the stock of the SFC on which the dividend is received for at least 366 days during the period that begins 365 days before the ex-dividend date with respect to the stock and that ends 365 days after that date. In addition, the foreign corporation must have been an SFC and the domestic corporation must have been a US shareholder with respect to the foreign corporation during the entire holding period.[2]

The purpose of enacting Code § 245A was to "allow US companies to compete on a more level playing field against foreign multinationals when selling products and services abroad by eliminating an additional level of tax [and to] eliminate the 'lock-out' effect under [prior] law. . . ."[3] The BBBA would limit the benefits of Code § 245A to foreign-source dividends received from a CFC, effectively eliminating the DRD for any corporate US shareholders of a foreign entity that is an SFC (under current law) but not a CFC. As a result, the proposal appears to narrow the original purpose of Code § 245A so that it applies only in respect of the residual earnings and profits ("E&P") of CFCs that is not captured by the subpart F and GILTI rules.

The changes to Code § 245A are proposed to be effective only after the date in which the BBBA is enacted; however, the IRS's regulatory authority could address certain transactions made on or after January 1, 2018.

L. CHANGES TO FOREIGN BASE COMPANY SALES AND SERVICES INCOME RULES

Under current law, Subpart F income generally includes income of a CFC derived in connection with the purchase of property from, or sale of property to, a related person or on behalf of a related person (foreign base company sales income) and income of a CFC derived from performing services outside of the CFC's country of incorporation for or on behalf of a related person (foreign base company services income). The BBBA would significantly narrow the scope of these types of Subpart F income by providing that, for these purposes, a "related person" only includes a related person that is a taxable unit which is a tax resident of the United States. As such, sales or services transactions between a CFC and a foreign affiliate generally would not give rise to Subpart F income and may instead result in tested income for purposes of the GILTI calculation.

In connection with this change, the BBBA would also eliminate the so-called "branch rules" for purposes of the foreign base company sales income determination. These changes would apply to tax years beginning after December 31, 2021.

M. CHANGES TO DETERMINATION OF PRO RATA SHARE OF SUBPART F AND GILTI INCOME

The BBBA would substantially modify the calculation of a US shareholder's pro rata share of Subpart F and tested income items from a CFC. Under current law, a US shareholder includes its pro rata share of Subpart F and tested income only to the extent it holds stock of a foreign corporation on the last day of the year on which such foreign corporation was a CFC. In addition, the US shareholder's pro rata share with respect to stock of a CFC is reduced to the extent of dividends

received by any other person during the tax year with respect to such stock (including any gains from the sale of stock recharacterized as a dividend under Code § 1248).

Under the BBBA, a US shareholder that owns stock of a CFC during the tax year may have an inclusion with respect to such stock even if they do not own such stock on the last day of the year on which the corporation was a CFC. In that case, the US shareholder's pro rata share would be based on the proportionate share of current earnings and profits ("E&P") received by the US shareholder (or by a CFC owned by such US shareholder) as a "nontaxed current dividend," that is, the portion of a dividend received from the CFC out of current year E&P that would be eligible for a Code § 245A deduction or, in case of a dividend between CFCs, that would be excluded from the recipient CFC's subpart F income under an applicable exception.

In turn, the US shareholder that owns stock of a CFC on the last day of the year on which the foreign corporation was a CFC would include its pro rata share of Subpart F income and tested income reduced by (i) the "nontaxed current dividends" received by any other US shareholder that previously owned the stock during the year, and (ii) any "pre-holding period dividends," which are dividends made out of the corporation's current E&P (other than non-taxed current dividends) received by any other US person with respect to the same stock while such foreign corporation was a CFC and before such US shareholder owned the stock. Through different mechanics, these changes would address situations already tackled by Treasury in existing regulations to prevent a US buyer of CFC stock from reducing its Subpart F income or tested income inclusion by reason of dividend income recognized by a US seller that goes untaxed under Code § 245A.

These changes would apply retroactively to distributions made after December 31, 2017.

N. MODIFICATIONS TO BEAT

The proposed legislation would make significant changes to the Code § 59A base erosion and anti-abuse tax ("BEAT") provisions. The changes are driven as much by the need for revenue offsets to pay for the broad infrastructure package as well as confirm BEAT to the changes required by OECD Pillar Two initiative.

BEAT was enacted as part of the TCJA and functions as a minimum tax by adding back to taxable income deductions for certain payments to related parties and applying the applicable BEAT tax rate (currently 10% and 11% for domestic banks) to modified taxable income. BEAT currently applies to corporate taxpayers with average annual gross receipts of at least $500 million.

The current BEAT rate is 10% and is scheduled to increase to 12.5% for taxable years beginning after December 31, 2025. The proposed legislation would accelerate the 12.5% rate for years beginning after December 31, 2023 and before January 1, 2026. The rate would be further increased to 15% for taxable years beginning after December 31, 2025. The increase to 15% would appear to be designed to confirm the BEAT rate with the global minimum tax rate required under Pillar Two.

Under current law, BEAT does not apply to a taxpayer if its base erosion percentage is less than 3% (2% for domestic banks). In general, the base erosion percentage is the ratio of base eroding payments to the aggregate amount of all deductions allowable to the taxpayer. While the 3% base erosion floor prevented some taxpayers from being subject to BEAT, the cliff effect of the threshold meant that once the threshold was exceeded, all payments were subject to BEAT even those below the 3% threshold.

The proposed legislation would eliminate the 3% threshold for taxable years beginning after December 31, 2023. The proposal would significantly expand the number of taxpayers subject to BEAT and represents a stinging blow to many taxpayers that restructured supply chains to eliminate base erosion payments so as to keep below the 3% threshold (again, 2% for domestic banks).

As important component of the Pillar Two global minimum tax rate proposal is a denial of deductions for payments made to related parties where the payments are not subject to the 15% global minimum tax. The Green Book proposed a reformulation of BEAT to conform with Pillar Two. The Green Book proposal, known as SHIELD (Stopping Harmful Inversions and Ending Low-Tax Developments), would have denied deductions for payments to foreign related parties if such payments were not subject to a sufficient level of foreign tax in the hands of the recipient.

Rather than replace BEAT with SHIELD as suggested by the Green Book, the proposed legislation lays SHIELD on top of BEAT by providing an exception from BEAT for payments that are subject to a rate of tax equal to the BEAT tax rates as adjusted by the legislation. While the proposed changes would seem to be designed to bring BEAT into conformity with Pillar Two, there is little guidance on how the foreign effective tax rate test will be measured. The legislation indicates that applicable financial statements may be used for this purpose but it seems clear that these rules will be left for regulatory guidance.

As noted above, many taxpayers restructured supply chains, distribution models and intercompany services arrangements in order to mitigate the effect of BEAT even where those payments were made to related parties in countries with tax rates in excess of 15%. The SHIELD overlay obviates the need for that restructuring although it is questionable whether multinationals will unwind structures put in place after the TCJA.

Under current law, a payment is not considered a base eroding payment if it is subject to the full 30% withholding tax. Where a treaty reduces the withholding tax, the payment is considered a base eroding payment for the portion of the payment not subject to withholding. For example, if a payment was subject to a 15% withholding tax, 50% of the payment would be considered a base eroding payment. The proposed legislation significantly expands the "subject to US tax" exclusion. Under the proposed rules, a payment that is subject to US tax in the hands of either the payor or the payee will be excluded. The exclusion for payments subject to withholding tax would continue to apply as well as payments which would be taxed as effectively connected income to the recipient.

Significantly, a payment to a controlled foreign corporation that is subject to GILTI would not be considered a base eroding payment notwithstanding the Code § 250 deduction for a GILTI inclusion. This is a welcome provision and eliminates the so-called "GILTI boomerang" effect. The legislative text requires that US tax is "*imposed…with respect to such amount*." It is not clear how tested losses and the QBAI exemption will impact this analysis.

The existing BEAT regulations contain an important exception for certain intercompany services. Under those regulations, a payment is not considered to be a base eroding payment if the payment meets the requirements for the SCM in Treasury Regulation § 1.482-9. The legislation would essentially codify the provisions in the regulations and remove any uncertainties as to the approach taken by Treasury when the regulations were finalized.

One of the most complex aspects of the proposed legislation is the expansion of base eroding payments to include certain indirect costs associated with cost of goods sold (COGS). Under current law, payments to a related foreign person for COGS are not included as base eroding payments

except to the extent such payments are made to an expatriated entity. The proposed legislation reduces the benefit of the COGS exception in two important ways. First, any payment to a foreign related party that the US payor is required to capitalize into inventory under Code § 263A would be considered a base eroding payment. For example, if a US payor makes a royalty payment to a foreign related party for the right to manufacture inventory items, that royalty will be considered a base eroding payment.

Second, the COGS exclusion for inventory acquired from a foreign related party would be limited to the (i) *direct* costs associated with acquiring the inventory and (ii) *indirect* costs of such foreign related party but only to the extent it is established that such indirect costs were paid to a US person, an unrelated foreign person or are otherwise subject to US tax in the hands of the recipient. In other words, the COGS exclusion for indirect costs is only available where inventory can be traced to third-party direct or indirect costs. To obviate the need to trace indirect costs, the legislation permits a taxpayer to elect to treat 20% of direct costs as indirect for purposes of the COGS exclusion.

The proposed legislation makes a number of changes to how net operating losses (NOLs) interact with BEAT. Under current law, for purposes of calculating modified taxable income, NOLs are added back to the extent of any base eroding payments which contributed to the NOL. Currently, 100% of the base eroding portion of the NOL is added back even though NOL's are limited to 80% of taxable income for regular tax purposes. The proposed legislation would equalize the treatment of NOLs for regular tax and BEAT purposes by providing that the NOL add-back for BEAT purposes is limited to 80% of the base eroding portion of the NOL.

O. AMENDMENTS TO CODE § 165(G) AND GRANITE TRUST TRANSACTIONS

The BBBA would modify the treatment of certain losses in a number of disjointed ways. The BBBA proposes to amend Code § 165(g) so that a loss from a worthless security is now realized on the day the security becomes worthless rather than on the last day of the taxable year. Realizing a loss earlier in the year could be significant for taxpayers who may now have to realize a short-term capital loss rather than a long-term capital loss due to the accelerated timing of when a loss is realized. It remains to be seen if the Proposal will provide clear rules for determining a singular identifiable event that causes a security to become worthless if a confluence of several events may have contributed to the ultimate worthlessness of a security. This provision would apply for tax years beginning after December 31, 2021.

The BBBA expands the definition of a "security" in Code § 165(g)(2) to not only include a bond, debenture, note or certificate of other evidence of indebtedness issued by a corporation, but also of a partnership so that partnership debt is treated in the same manner as corporate debt in the context of worthless securities. This change would apply for tax years beginning after December 31, 2021.

A loss from a worthless partnership interest is to be treated under the BBBA as a loss that arises from a sale or exchange of a partnership interest. The loss would be a capital loss under Code § 741 unless attributable to unrealized receivables and inventory items under Code § 751. The treatment of abandoned partnership interests is not addressed by the BBBA. This provision would apply for tax years beginning after December 31, 2021.

The BBBA has a new provision under Code § 267 where a distributee corporation cannot recognize a loss on stock or securities received from a liquidating corporation in a complete liquidation to which

Code § 331 applies until the distributee corporation has disposed of substantially all property received in such liquidation to unrelated persons.

The BBBA targets *Granite Trust* transactions, named after the case *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956) where it was held that a parent corporation could proactively sell off stock held in a subsidiary to receive taxable treatment of the subsidiary's liquidation and recognize a loss. Generally under a *Granite Trust* transaction, a parent corporation sells a part of its interest in a liquidating subsidiary to an affiliate outside the parent's consolidated tax group, such as a foreign subsidiary or related partner, to lower the parent's stock ownership below the 80% threshold to avoid non-recognition treatment under Code § 332 and recognize a loss under Code § 331.

Code § 267(f) currently defers or disallows losses between corporations in the same controlled group, so that a loss on subsidiary stock sold by the parent corporation to an affiliate is deferred until the property is transferred outside the controlled group and there is a recognition of loss under consolidated return principles or as prescribed in the regulations. Code § 267(f) does not, however, defer any loss a parent would recognize on its remaining interest in the liquidating subsidiary. For this purpose, "controlled group" is defined in reference to Code § 1563, requiring 50% instead of 80% of total combined vote or value. New Code § 267(h) would prevent the parent corporation from recognizing loss from the stock or securities exchanged in the subsidiary's complete liquidation until the parent disposes of such property to an unrelated person. Following the passage of this provision, it would no longer be sufficient for a parent to partially sell off its interest in a liquidating subsidiary to fall below the 80% threshold to recognize a loss under Code § 331. The parent would now need to dispose of its interests in the liquidated subsidiary to recognize a loss. This provision looks to sharply curtail *Granite Trust* transactions and will apply to liquidations on or after the date of enactment.

P. ADJUSTED BASIS LIMITATION FOR DIVISIVE REORGANIZATION

In a reorganization pursuant to Code §§ 368(a)(1)(D) and 355 (i.e., spin-offs and split-offs), Code § 361(a) generally provides that the distributing corporation does not recognize gain or loss on its transfer of property to the controlled corporation in exchange for stock or securities in the controlled corporation. To the extent the distributing corporation receives property other than stock or securities (i.e., boot) from the controlled corporation, Code § 361(b)(1) generally provides that the distributing corporation does not recognize gain if the distributing corporation distributes such property pursuant to the plan of reorganization.

The transfer of boot by the distributing corporation to its creditors in connection with the reorganization is also generally considered a distribution under Code § 361(b)(1). However, under current law, nonrecognition on such distribution only applies to the extent the boot transferred to creditors does not exceed the adjusted bases of the assets transferred.

The BBBA seeks to further expand this limitation by requiring the distributing corporation to recognize gain to the extent of boot exceeding (A) the sum of (i) the total amount of liabilities assumed by the controlled corporation, (ii) the total amount of boot transferred to the creditors, and (iii) the total principal amount of securities of the controlled corporation which is qualified property transferred to the creditors over (B) the total adjusted bases of the assets transferred by the distributing corporation to the controlled corporation. In other words, this proposal would further limit the distributing corporation's ability to allocate its debt to the controlled corporation on a tax-free basis since the proposed limitation would also take into account the total principal amount of securities of the controlled corporation transferred to creditors.

As currently drafted, the proposed amendment to Code § 361 would apply to reorganizations occurring on or after the proposed legislation without a transition rule for deals in progress.

Q. MODIFICATIONS TO EXEMPTION FOR PORTFOLIO INTEREST

The portfolio interest exception allows US obligors on debt instruments to pay interest free from US withholding tax to non-US persons. When the portfolio interest exception does not apply, the US withholding tax rate on interest is 30%, unless reduced by a tax treaty. Not all interest paid to non-US persons qualifies as portfolio interest. Interest that is paid by a US obligor to a non-US person who is treated as a "10% shareholder" of the US obligor (of holder of 10% or more of the capital or profits interest in a US obligor that is a partnership) is carved out of the portfolio interest exception. Under current law, a 10% shareholder is a non-US person who actually or constructively owns 10% or more of the voting stock of the obligor.

The BBBA would expand the definition of a 10% shareholder to include a non-US person who actually or constructively owns 10% or more of the vote or value of the stock of a US corporate obligor on a debt instrument held by the non-US person. The BBBA proposes to implement this rule for debt instruments issued after the date of enactment of this change. Thus, all debt instruments issued prior to this date would be grandfathered from its application.

R. PAYMENTS EQUIVALENT TO PUBLICLY TRADED PARTNERSHIP INCOME PAYMENTS

Code § 871(m) treats "dividend equivalent payments" made to non-US persons in respect of dividends paid on US stocks in sale-repurchase transactions and specified notional principal contracts (a/k/a "Swaps") as dividends subject to US withholding tax. In other words, a non-US person cannot obtain a better tax result by gaining exposure to a US stock through a derivative or lending it out over a dividend record date. The breadth with which the Internal Revenue Service has sought to implement this rule has made this relatively straightforward statutory mandate an extremely difficult rule to navigate in the structured product arena and for non-delta one financial products. At the current time, the rule for dividend equivalent payments only applies to exposure provided to US stocks.

The BBBA would expand the reach of Code § 871(m) to include derivatives referencing US publicly traded partnerships ("PTPs") in an unusual way. Specifically, a derivative that made a payment that "is determined by reference to any income or gain in respect of an interest in a [PTP]" would be treated as a dividend equivalent payment. In the absence of an applicable income tax treaty, this rule would subject such payments to a 30% withholding tax. If the non-US recipient of the dividend equivalent payment was eligible for the benefits of an income tax treaty that provided for lower withholding tax rates on dividends, an unresolved issue arises as to whether as payment made in respect of a partnership interest would be eligible for such lower rate. If, however, the treaty contains an "Other Income" provision preventing the imposition of tax on income and gains not enumerated in the treaty, the non-US person should have a position that such Other Income provision prevents the application of the revised Code § 871(m) rule.

If enacted, the changes to Code § 871(m) would apply to payments made 180 days after the date of enactment, regardless of when the derivative was entered into.

S. ADJUSTMENTS TO EARNINGS AND PROFITS OF CFCS

The determination of E&P of a CFC under current law generally disregards the application of certain accounting methods, such as LIFO inventory adjustments, the installment method and the completed

contract method of accounting. As such, a CFC may accelerate the recognition of earnings for E&P purposes, while the corresponding income is still not otherwise recognized. The BBBA would change this result such that E&P of a CFC are computed by taking into consideration such special accounting methods. This change would apply to tax years of foreign corporations beginning after December 31, 2021.

T. AMENDMENTS TO CODE § 1059

As a general matter, Code § 1059 requires a reduction in basis in stock held by a corporation if the corporate shareholder receives an extraordinary dividend on stock held for two years or less prior to the dividend announcement date. Pursuant to the proposal, any disqualified CFC dividend is treated as an extraordinary dividend without regard to the period the taxpayer held the stock to which such dividend relates. For purposes of this proposal, a disqualified CFC dividend means any dividend paid by a CFC to a US shareholder if such dividend is attributable to earnings and profits which were earned, or are attributable to gain on property which accrued, while such foreign corporation was not a CFC or such stock was not owned by a US shareholder. These amendments will apply to distributions made after the date of enactment of the legislation.

U. CHANGES TO CODE § 1061

The TCJA contained the first set of rules to curtail the tax advantages of certain "carried interests"—profits interests in partnerships (designated as an applicable partnership interest or API)—issued as compensation for investment management. Specifically, the TCJA included Code § 1061, which extends the holding period to achieve long-term capital gain with respect to such interests from one year to three years. To determine the amount of gain recharacterized as short-term, Treasury Regulation § 1.1061-4(b)(9) looks through to the holding period of a disposed API's underlying assets if the API would have a holding period of three years or less counting from when an unrelated non-service partner is legally obligated to contribute substantial (at least 5% of the partnership's capital) money or property to the partnership.

The current law also imposes a look-through rule triggered by a taxpayer's transferring an API to a related person. Specifically, it converts to short-term capital gain any long-term capital gain with respect to the transferred interest attributable to the sale or exchange of an asset held for three years or less, to the extent not already treated as such under the section. By regulation, this amount is calculated by attributing to the transferor a ratable portion of the gain the partnership would recognize if it sold all of its assets held for less than three years immediately prior to the transfer.

The proposed amendment completely repeals and replaces the basic mechanism of Code § 1061, expanding the short-term capital gain treatment to a five-year holding period calculated in a more onerous and ambiguous manner. It starts by extending short-term capital gain treatment to *any* net long-term capital gain with respect to an API and any other amounts included as gross income with respect to one or more APIs treated as capital gain or taxed at the capital gain rate. It is possible this broad language expands the scope of a taxpayer's distributive partnership income affected by the section to include amounts specifically excluded under the current regulations: Code § 1231 capital gain and loss (property used in trade or business); Code § 1256 capital gain and loss (contracts marked to market); qualified dividend income, which is taxed at capital gain rates; and capital gains and losses characterized without regard to the holding period rules, such as those under mixed straddle rules.

From there, the proposal excepts amounts realized five years after *the latest of* (i) when the taxpayer acquired substantially all of the applicable partnership interest or (ii) when the partnership acquired substantially all of its assets. It is unclear how these "substantially all" standards should apply.

The proposal carves out an exception imposing only a three-year holding period for (i) taxpayers (other than trusts and estates) with modified AGI below $400,000 and (ii) income attributable to a partnership's real property trade or business.

The House's proposal codifies a modified version of the regulations' limitation on the exception of partnership interests held by corporations. The regulations excluded S corporations and PFICs with pass-through elections from the definition of a "corporation," for purposes of the rule that corporations' direct or indirect partnership interests are not APIs. The new rule would simply exclude from the definition of API any partnership interest held by a "C corporation."

The proposed amendment completely removes the look-through for the transfer of an API to a related person and replaces it with a provision that for any transfer of an API "gain shall be recognized notwithstanding *any* other provision of this subtitle."

At the same time, however, the amendment removes the provision that looks through to the assets held by an API transferred to a related-party to recharacterize long-term gain to short-term gain.[4] Regulations have been issued to implement this look-through recharacterization, but it appears they would no longer carry any force following the effective date of the proposed amendment.

The proposed amendment would be effective for tax years beginning after December 31, 2021.

V. LIMITATION ON CERTAIN SPECIAL RULES FOR CODE § 1202 GAINS

Code § 1202 permits non-corporate holders of a C corporation to exclude a certain percentage of the "eligible gain"[5] from the sale of "qualified small business stock" held for more than five years. Generally, stock acquired after September 27, 2010 is eligible for a 100% exclusion of eligible gain. The proposed legislation modifies this rule so that any taxpayers with an adjusted gross income (determined without regard to Code §§ 1202, 911, 931 and 933) that equals or exceeds $400,000, as well as taxpayers that are trusts or estates, would only be permitted to exclude 50% irrespective of when a taxpayer acquired her qualified small business stock. For these taxpayers, this change reverts the Code § 1202 benefit to its state as originally enacted.[6] As proposed, this change would apply to sales or exchanges made on or after September 13, 2021, other than those for which a written binding contract was in effect prior to that date (as long as the contract is not materially modified after that date).

W. CONSTRUCTIVE SALES EXPANDED TO CRYPTOCURRENCIES

The constructive sale rules cause certain hedging transactions entered into with respect to "appreciated financial positions" to trigger unrealized gain with respect to such positions. Appreciated financial positions include positions in publicly traded stock and convertible debt instruments. The BBBA would treat positions in cryptocurrencies in which there is unrecognized gain for federal income tax purposes as appreciated financial positions. This change would be effective for hedges of such positions initiated after the date of enactment of the new rule. In addition, the BBBA would expand the rule for hedging short positions by treating a contract to enter into a long position as a constructive sale, for transactions entered into after the date of enactment of the BBBA.

X. RULES RELATING TO COMMON CONTROL

Several sections of the Code require taxpayers to aggregate entities with other commonly controlled entities to determine whether certain thresholds are met. For example, for purposes of determining whether a taxpayer is exempt from Code § 163(j) by reason of having gross receipts of less than $25 million, a taxpayer is required to aggregate any other entities that are under common control. These aggregation rules are found, in part, in Code § 52, which provides for aggregation of commonly controlled corporations and commonly controlled trades or businesses, whether or not controlled. The BBBA would clarify that, under Code § 52, the term "trade or business" includes any activity treated as a trade or business under Code § 469(c)(5) (relating to trades or business involving research and experimentation activity) or Code § 469(c)(6) (relating to activity in connection with a trade or business or any activity with respect to which expenses are deductible under Code § 212). These changes would apply to tax years beginning after December 31, 2021.

Y. UPDATING THE WASH SALE RULES

Under the wash sale rules, if a taxpayer acquires, or enters into a contract to acquire, substantially identical stocks or securities ("replacement property") that he sold at a loss within the wash sale period, the loss on the sold stock or securities is disallowed. The wash sale period is the 61-day period beginning 30 days before the sale of the loss position. The BBBA would implement several changes to the wash sale rules, all beginning in 2022.

First, the BBBA would change the rule regarding the disallowed loss itself. Under the current rules, if a loss is disallowed, the basis of the replacement property is increased by the disallowed loss. Under the BBBA rule, the basis of the replacement property is increased only if the replacement property is acquired by the taxpayer or his spouse. It appears that if the replacement property is acquired by another person who triggered the application of the wash sale, no basis adjustment would be permitted.

Second, the BBBA would expand the list of persons acquiring replacement property that would trigger a wash sale. Under the BBBA, wash sales results are triggered if the during the wash sale period replacement property is acquired by the taxpayer's spouse, the taxpayer's dependents, any entity that the taxpayer controls (generally using a 50% ownership test), the taxpayer's IRA, a Code § 529 plan or an employee annuity.

Third, the assets subject to wash sale treatment are greatly expanded to include any stock (whether or not publicly traded), a widely held partnership interest, any debt instrument, any derivative, foreign currencies, commodities and cryptocurrencies.

Fourth, the BBBA contains a provision that would exempt wash sale treatment to foreign currency and commodity transactions that are directly related to the "business needs of a trade or business" or that is part of a hedging transaction.

Part II – Tax Increases for High-Income Individuals

A. INCREASE IN TOP MARGINAL INCOME TAX RATE

The BBBA proposes to increase the top marginal individual income tax rate from 37% to 39.6%. This new rate would apply to taxable income over (i) $450,000 for married individuals filing a joint return, (ii) $400,000 for unmarried individuals, (iii) $425,000 for head of households filers, and (iv) $225,000 for married individuals filing a separate return. The income brackets at which this highest rate of tax

would apply would be indexed for inflation after the 2022 tax year. This proposal would apply to taxable years beginning after December 31, 2021.

B. INCREASE IN CAPITAL GAINS RATE

Under current law, long-term capital gains and qualified dividends are subject to income tax at a rate of 0%, 15% or 20%, with the applicable tax rate based on a taxpayer's taxable income and filing status. The BBBA would increase the top rate imposed on long-term capital gains and qualified dividends from 20% to 25% for tax years ending after September 13, 2021 (i.e., the date of introduction of the proposal), while the statutory rate of 20% would continue to apply for qualified dividends, gains and losses for the portion of the 2021 tax year ending on the date of introduction. Under the BBBA, for the period of September 14 through December 31, 2021, the 25% tax rate would apply to taxpayers currently subject to the 20% rate. However, for 2022 and future years, the increased rate will apply to taxpayers subject to the highest ordinary income rate (39.6%). Under the proposal, gains recognized in a tax year that includes September 13, 2021 that arise from transactions entered into on or prior to September 13, 2021 pursuant to a written binding contract will be treated as occurring prior to the date of introduction.

C. APPLICATION OF NET INVESTMENT INCOME TAX TO TRADE OR BUSINESS INCOME OF CERTAIN HIGH-INCOME INDIVIDUALS

The BBBA would expand the 3.8% net investment income tax under Code § 1411 to cover net investment income derived in the ordinary course of a trade or business for taxpayers with greater than $400,000 in taxable income (single filer) or $500,000 (joint filer), as well as for trusts and estates. This provision is intended to ensure that individuals with interests in pass-through entities will be subject to the net investment income tax or the 3.8% self-employment Medicare tax on all income (whether wages, passive income, or active business income) derived from such entities.

D. LIMITATION ON DEDUCTION FOR QUALIFIED BUSINESS INCOME

Under the BBBA, the qualified business income deduction of Code § 199A would be limited for certain high-income individuals. Under current law, Code § 199A effectively allows non-corporate taxpayers a 20% deduction for certain pass-through income. Specifically, this deduction equals the lesser of (i) the taxpayer's "combined qualified business income amount" (income from qualified trades or businesses carried on by the taxpayer, plus 20% of qualified REIT dividends and qualified publicly traded partnership income) and (ii) 20% of the excess of the taxpayer's taxable income over the taxpayer's net capital gain.

The BBBA would cap the overall amount of the deduction at: (i) $500,000 in the case of a taxpayer filing a joint return or a surviving spouse; (ii) $400,000 in the case of a single taxpayer; (iii) $250,000 in the case of a married taxpayer filing a separate return; and (iv) $10,000 in the case of an estate or trust. This change would be effective for taxable years beginning after December 31, 2021.

E. LIMITATIONS ON EXCESS BUSINESS LOSSES OF NON-CORPORATE TAXPAYERS

The BBBA would amend Code § 461(l), which currently is scheduled to sunset after December 31, 2025, to permanently disallow excess business losses (i.e., net business losses in excess of business income) for non-corporate taxpayers with losses in excess of $250,000 ($500,000 in the case of a joint return). Code § 461(l) allows taxpayers with disallowed losses to carry those losses forward but such losses would continue to be subject to the excess business loss limitation rather than being carried forward as net operating losses.

F. SURCHARGE ON HIGH-INCOME INDIVIDUALS, TRUSTS AND ESTATES

The BBBA would enact a new Code § 1A, which would impose a tax equal to 3% of a taxpayer's modified adjusted gross income in excess of $5 million (or $2.5 million for a married individual filing separately). For this purpose, "modified adjusted gross income" would be adjusted gross income reduced by any deduction allowed for investment interest (as defined in Code § 163(d)).

Part III – IRS Funding and Practice

A. APPROPRIATION OF APPROXIMATELY $80 MILLION FOR THE IRS

The BBBA would provide roughly $79 billion in funding for the IRS to strengthen tax enforcement activities and modernize information technology to support enforcement activities. The Commissioner of the IRS, Charles Rettig, has been advocating strongly for additional funding. It remains to be seen how much revenue the CBO estimates will result from the additional funding, but one thing is clear—corporations, partnerships, and high net worth individuals (explicitly any taxpayer with taxable income above $400,000)—should expect more audits in the forthcoming years.

B. MODIFICATION OF PROCEDURAL REQUIREMENTS RELATING TO ASSESSMENT OF PENALTIES

The BBBA would also repeal a requirement that any assessment of penalties must be approved by a supervisor of the employee making such determination as currently provided for in Code § 6751(b)(1). The repeal of Code § 6751(b)(1) would be retroactive to penalties assessed since December 2000 and would put a stop to litigating whether the assessed penalty was properly approved, the subject of much litigation since the Tax Court first decided *Graev v. Commissioner*, 149 T.C. 485 (2017), in 2017.

Part IV – Other Provisions

A. CLARIFICATION OF TREATMENT OF DISC GAINS AND DISTRIBUTIONS OF CERTAIN FOREIGN SHAREHOLDERS

A US corporation that meets certain requirements can elect to be treated as an interest charge domestic-international sales corporation (an "IC-DISC"). An IC-DISC is ordinarily not subject to tax. Instead, its shareholders are generally taxed upon distribution of profits from the corporation.

Under current Code § 996(g), distributions to a foreign shareholder of an IC-DISC are treated as distributions which are effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder. The BBBA would amend Code § 996(g) to change the phrase "permanent establishment of such shareholder" to "permanent establishment deemed to be had by such shareholder." This amendment is effective for distributions on or after December 31, 2021.

B. REIT CHANGES

i. Prison REITS

The proposal would significantly modify the rules for the prison REIT industry. Effective for taxable years beginning after December 31, 2021, the proposal would amend Code § 856(d)(2) by adding to the list of amounts excluded from the definition of "rents from real property" any amounts received

or accrued, directly or indirectly, with respect to any real or personal property which is primarily used in connection with any correctional, detention, or penal facility.

ii. Modification of REIT Constructive Ownership Rules

Unlike many of the changes discussed above, the amendment to the REIT constructive ownership rules is taxpayer-favorable. Under Code § 856(d)(2), the definition of "rents from real property" generally excludes rents received from a corporation of which REIT actually or constructively owns by 10% or more (by vote or value) or other entity where a REIT owns 10% or more of the assets or net profits of the entity. Code § 856(d)(5) applies the constructive ownership rules of Code § 318(a) for purposes of this determination, with some modifications.[7] The proposal adds a new modification, stating that the stock, assets and net profits constructively owned by a partnership, estate, trust or corporation by reason of downward attribution under Code § 318(a)(3) are not considered as owned by it for purposes of again applying the downward attribution rules to make another person a constructive owner of the stock, assets or net profits.

Endnotes

[1] Mr. Zappa was the Czechoslovakia Special Ambassador to the West on Trade, Culture and Tourism in 1990 until he was removed from such post at the request of then-Secretary of State James Baker. Mr. Zappa died in 1993.

[2] Code § 246(c).

[3] S. Comm. on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. No. 115-20, at 358 (Comm. Print 2017).

[4] *See* Code § 1061(d)(1)(A).

[5] A taxpayer's "eligible gain" is generally the greater of (i) $10 million and (ii) 10 times the aggregate adjusted basis of the qualified small business stock issued by the corporation and disposed of by the taxpayer during the taxable year.

[6] The 75% and 100% exclusions were added to the Code in 2009 and 2010, respectively.

[7] The constructive ownership rules are also relevant to REITs in determining whether a person qualifies as an "independent contractor" under Code § 856(d)(3).

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